

## **GUIDELINES FOR HEDGE FUND INVESTMENT**

1. Massachusetts public retirement systems may consider “hedge funds” as a way to achieve additional diversification in their portfolios. The term “hedge funds” generally refers to unregulated investment products that seek absolute returns through the use of specialized investment strategies that are expected to have low correlation to the major financial markets. Products that involve strategies basically similar to those of traditional active management approaches will not be approved. Hedge funds should be seen as a component of a portfolio’s long-term asset allocation.
2. PERAC staff will consider requests for authorization to invest in hedge funds on a case-by-case basis. Only retirement boards with investment assets in excess of \$250 million may request authorization. Total investment in hedge funds cannot exceed 5% of portfolio assets, based on current market valuation. In its determination, PERAC may take into account such factors as the retirement board’s past investment performance, the system’s funded ratio, and the board’s record of compliance with PERAC regulations and guidelines.
3. In structuring their proposed hedge fund investments, retirement boards should 1) emphasize diversification among strategies and managers, such as through the use of fund(s) of funds, 2) focus on the more conservative, non-directional hedge fund strategies or funds of funds consisting primarily of such strategies, 3) consider only hedge funds or fund products that will offer best practices with regard to portfolio transparency, 4) consider only hedge funds or fund products where the current or potential use of leverage is limited to one time existing capital. Hedge funds or fund products that have registered with the appropriate federal regulatory agency should be preferred over those that have not.
4. Boards must work with an investment consultant who has experience in analyzing, conducting searches for, and monitoring hedge funds, preferably for institutional clients. For some boards, this may involve retention of a consultant separate from the one it currently uses for traditional asset classes. While using the consultant for educational purposes and for assistance in conducting a search, the retirement board should 1) have a basic understanding of the investment strategies involved and 2) be committed to making final decisions on its own relative to any investment in hedge funds.
5. Boards should work with their consultant to determine various parameters that would govern their search, such as 1) what minimum levels of assets under management or length of investment track records should be applied to potential hedge fund or fund of funds managers, 2) what constitutes best industry practices with regard to portfolio transparency, 3) what minimal levels of investment liquidity (e.g., semiannual) should be required, 4) whether or not only funds with existing public pension clients should be considered, 5) what range of fee structures for the fund of funds and/or separate funds would be considered appropriate, and 6) what contractual issues (i.e., indemnification) with the potential manager(s) need to be addressed.
6. Before beginning a search, the board must submit a letter to PERAC staff summarizing its objectives, in the context of overall asset allocation, in investing in hedge funds and explaining in detail how its hedge fund investments would be structured in order to accomplish those objectives. If the board has not received notice from PERAC within ten business days, it may commence its search process. A fair and open competitive process is required for selection,

including the issuance of an RFP. These guidelines should be distributed to potential managers as part of the RFP.

7. After completing its search, the board must submit a letter to PERAC staff which 1) certifies that the hedge fund or fund of funds manager was selected as a result of a competitive process (a summary of and timeline for the process should be included) and that the consultant supports the selection; and 2) reports on the major steps (interviews, reference checks, etc.) included in the due diligence process conducted by the board and its consultant.

8. The board should inform PERAC that its legal counsel has examined the terms of the proposed investment contract and has advised the board that signing the contract is consistent both with these guidelines and with the board's fiduciary responsibility.

9. Selected hedge fund or fund of fund managers will complete PERAC Disclosure Statement and Vendor Certification forms as part of the RFP process. Besides clearly stating the structure of management fees inherent in the product, managers must disclose any financial arrangements between themselves, consultants, and any other third parties. On an Application for Exemption, managers will submit detailed information to PERAC staff on their key personnel, assets under management, investment strategy, investment process, risk control, organizational structure, performance record, et al. PERAC will refuse to issue regulatory approval for managers it deems to have clearly insufficient or questionable credentials and who fail to meet reasonable standards of experience and capability. The Commission will also deny an application if the process used to select the manager was flawed or where financial arrangements raise concerns regarding the selection process. As with any proposed investment, "The Commission may withhold approval of an exemption if it is in the best interests of the retirement system." (840 CMR 19.02-3)

10. The hedge fund or fund of funds manager will send quarterly performance reports to the board and to PERAC on a timely basis. Reports from fund of funds managers should include detailed information on each constituent fund. The retirement board and its consultant should meet with its hedge fund or fund of funds managers for a performance and strategy review at least once a year.

11. At the time of investment and at any time during the holding period, a particular Massachusetts retirement fund should not represent more than 10% of an individual manager or fund of funds' total assets and Massachusetts public funds together should not represent more than 50% of the total assets in the product.